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TAGS: [ECON](#) [EFIN](#) [SP](#)

SUBJECT: TREASURY A/S LOWERY MEETING WITH SPANISH SECRETARY
OF STATE FOR ECONOMY VEGARA

REF: A. MADRID 285

[1](#)B. MADRID 286

Classified By: Charge d'Affaires Hugo Llorens, for reasons 1.4(b) and (d)

[1](#)1. (C) Summary: Spanish Secretary of State for the Economy Vega told Assistant Secretary Lowery that he expected Spanish growth rates to fall below two percent as a result of the housing slump, which had been complicated by international credit market difficulties. He cited as helpful the government budget surplus and a sound financial system. While the Spanish adjustment would be painful in some areas, he said the economy could cope. In response to questions from Vega, the Assistant Secretary discussed the U.S. policy response to housing and financial market turmoil and the Administration's blueprint for financial regulatory reform. Vega also made a pitch for European Commission participation in the Financial Stability Forum, and the Assistant Secretary emphasized the importance of robust IMF surveillance of China's exchange rate regime in the upcoming Article IV consultations. End Summary.

[1](#)2. (U) Assistant Secretary of the Treasury for International Affairs Clay Lowery met with Spanish Secretary of State (vice minister) for the Economy David Vega on May 4 at the Asian Development Bank Annual Meeting in Madrid. Assistant Secretary Lowery was accompanied by Multilateral Development Banks office director Mark Jaskowiak and East Asia office director Mathew Haarsager. Vega was accompanied by Director General for International Financing Isabel Riano and Deputy Director General for Multilateral Financial Institutions Luis Orgaz.

Spanish Housing Market and Growth

[1](#)3. (C) Vega described Spain's recent rapid reduction in housing starts. Demographic factors led generated an average demand of 400-500,000 new residences a year, but 700,000 had been built in 2006 and only slightly fewer in 2007. A significant adjustment had been inevitable, and with residential construction accounting for 8 or 9 percent of GDP, the adjustment would affect the whole economy. Even if the international credit market situation did not deteriorate further, Vega expected a rapid decline in the next two to three quarters to where Spanish growth would be below 2 percent. (Note: This is on a year-on-year basis, and quarter-on-quarter growth would be somewhat lower at the lowest point.) If the rest of the economy performed reasonably well, Vega expected around 350,000 housing starts per year until 2010, when the rate would return to the 400-500,000 level.

[1](#)4. (C) Spain had two noteworthy advantages, Vega said. The first was the public sector budget surplus, which was around

2.2% of GDP last year. While he acknowledged that the surplus could be eroded quickly, it was much better to enter &complex8 times with a surplus than a deficit. Although there was talk in the press of additional public works, public investment already was high at 4% of GDP, and he did not expect a major increase. The GOS would focus its efforts on increasing the amount of public housing and on encouraging renovation of existing housing. He said the GOS could help make the market adjustment a little less painful but could not prevent the adjustment.

15. (C) Spain,s second advantage was that its financial system was &pretty sound.8 Spain,s financial market had been growing so rapidly that banks had not needed to get into products like foreign mortgage-backed securities. He said the Spanish regulatory requirement for cyclical provisioning, in which the faster credit increased, the higher amount of provisions were required, had resulted in more than sufficient provisions for the current situation. Vegara concluded the adjustment would be painful in some areas, but that the economy could cope.

16. (C) In response to questions from Assistant Secretary Lowery, Vegara said Spanish banks had no off-balance sheet vehicles because they would be required to consolidate them. This had not limited securitization to date, as Spain,s secondary mortgage market was Europe,s second largest. Over the last decade, Spanish banks had not had trouble selling mortgages, but recently Spanish mortgages had been contaminated by the U.S. subprime market. He did not expect this to be a long-term problem, and he said the issue was not asset quality but liquidity, as funds from elsewhere in Europe had stopped suddenly. He noted that large Spanish banks and savings banks were reporting strong first quarter

results and were doing so quickly in an effort to show markets that they were in good shape. While the rate of nonperforming loans had risen, it was still low, especially compared to the rates elsewhere in Europe.

USG Policy Response to Economic Situation

17. (SBU) Vegara expressed interest in the U.S. policy reaction to housing market difficulties. The Assistant Secretary explained the administrative action to eliminate taxation of foreclosures and the Administration,s efforts to work with Congress on expanding FHA authority. He described the HOPE Now program for encouraging voluntary debt workouts between mortgage originators and homeowners. He also explained the Federal Reserve,s actions to provide liquidity, lower interest rates, and help make possible the sale of Bear Stearns. He also noted that the Administration had not used taxpayer funds or set up anything like the Resolution Trust Corporation. The Assistant Secretary and Secretary Vegara also discussed Congressional views.

U.S. Regulatory Reform

18. (SBU) In response to questions from Secretary Vegara, Assistant Secretary Lowery discussed the Administration,s proposal for regulatory reform. He noted the variety of different regulators that existed in different sectors for historical reasons. He said plans for the reform blueprint had been underway for some time but that recent developments had strengthened the case for reform. He noted that getting any legislation passed this year would be difficult. He thought the U.S. needed more efficient regulation, but he did not have a view on whether the U.S. needed more regulation, and he warned of the temptation to swing the pendulum toward overregulation.

Multilateral Institution Issues

19. (SBU) Secretary Vegara cited the importance of international coordination and information exchange in the current situation. He chaired the EU Financial Services Commission and welcomed the good flow of information with the

U.S. Assistant Secretary Lowery noted that the U.S. had worked with the Financial Stability Forum. Vegara said it was important for the European Commission to participate in the Forum, though he acknowledged that the large number of European members already on the Forum could be a problem. The Assistant Secretary emphasized the importance of the IMF carrying out robust surveillance of China,s exchange rate regime in the upcoming Article IV consultation. Vegara acknowledged the importance of a serious IMF review, and he said he hoped the final result would recognize some positive Chinese movement, indicating that to do otherwise would be counterproductive.

¶10. (U) Assistant Secretary Lowery has cleared this message.
Llorens